DOW THEORY LETTERS INC.

RICHARD RUSSELL
P.O. Box 15196
San Diego, California 92115

40 Letters per Year — $50.00 Annually

Registered with the Securities Exchange Commission

May 4, 1965 Letter 287

THE MARKET: Robert Rhea, the great Dow Theorist of the 1930's, defined a bull market peak as the point at which the two Averages (Industrials and Rails) record their final joint highs (i.e., the highest points they reach together). The last joint highs of this bull market were established on October 20, 1964. In the six months since then, Industrials have tacked on another 4½%. Rails, on the other hand, have persistently refused to better their October (224.91) high.

The question is asked: "How can we prove it's still a bull market with Rails failing to move to new bull market highs?" The answer is that according to Dow's Theory the last major trend is conceded to remain in force until proved otherwise. The last major trend was clearly bullish, and until a bear signal is given, Dow Theorists will infer that the primary bull trend is still intact.

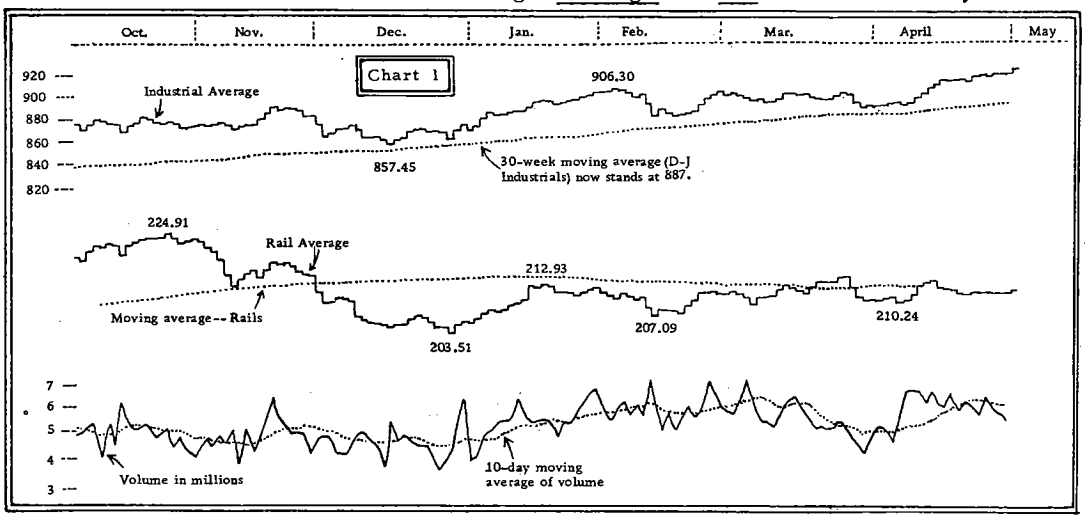
What is the meaning of the series of historic highs in the Industrial Average? As far as Dow's Theory is concerned, the new Industrial highs (unconfirmed by Rails) mean nothing. Furthermore, history shows that a new high on a single Average unconfirmed by the other Average may be deceptive. Many major reversals have been signalled by just such action.

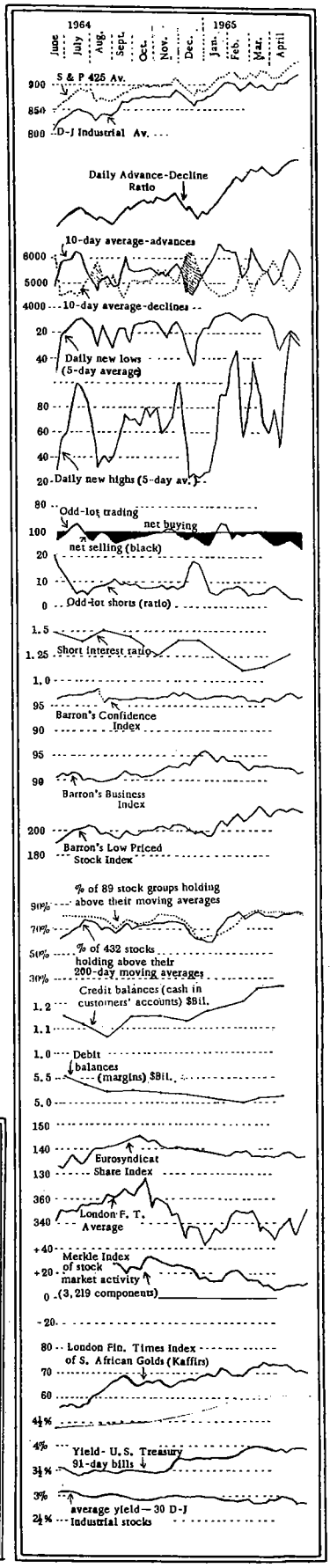
Could Rails still confirm? Yes, they definitely could. Dow's Theory places no time limit on the confirmation principle. But the strongest movements of the past sixty years have usually been accompanied by successive new highs in both Averages. A series of non-confirmations by either Average generally seems to exert a "braking" effect on the market, whereas an area of definite divergence (one Average rising while the other actually declines) usually results in erratic or unsatisfactory action in the general market.

What would constitute a bear signal under Dow Theory? An Industrial and Rail penetration of their December reaction lows of 857.45 and 203.51 respectively. However, as stated in the last Letter (see Chart 1) I would take a dim view of a series of Rail closings first below 210.24, then below 207.09 and finally below 203.51. Although Rails have not been able to rise to new highs since last October, the series of rising Rail bottoms has been impressive enough (in a secondary sense) to sustain the market rise so far. But a reversal of this Rail structure could be the forerunner of weakness in the whole market.

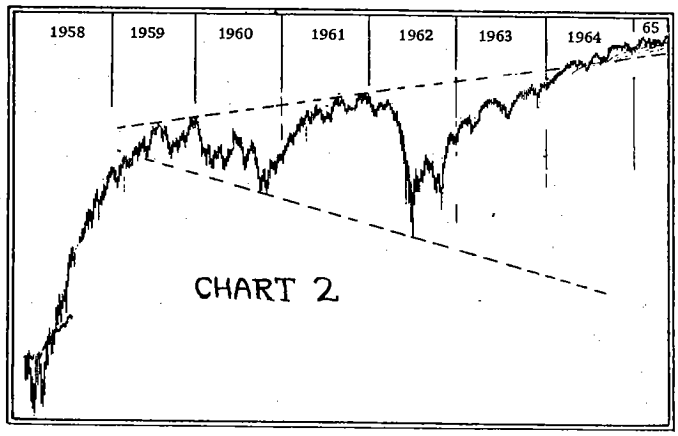
Since I have been putting so much emphasis on the Rail Average, I thought it would be interesting to "take that Average apart." This I did last week. If a stock's 200-day moving average is declining, and that stock continues to hold below its declining moving average, I classify the stock as definitely bearish. Of the 20 stocks in the D-J Rail Average, 12 are now bearish, 1 is neutral, and the rest (7) are bullish. This is not a promising showing, and it makes me think that a lower trend for the Rail Average is a distinct possibility over the period ahead.

The Composite Chart shows both leading industrial averages at approximately all-time highs with the A-D ratio only slightly below its 1962-65 high. The 10-day averages of advances and declines indicate that market breadth has been correcting. New highs and lows are still favorable, while

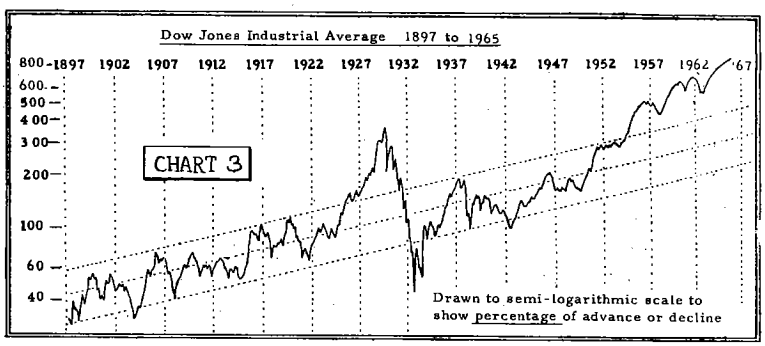




odd-lotters remain heavily committed to the selling side. After rising to within a fraction of its November (97.6) high, Barron's Confidence Index has again drifted off. The April figures showed debit (margin) balances up a slight $42 million and credit balances up $10 million. The fact that both of these indicators rose is at least short-term constructive. London has rallied sharply on the release of the news that Mr. Wilson intends to nationalize the steel industry. The market in London could be advancing because the "bad news" is now in the open and out of the way — or (considering the fact that the previous secondary high has now been bettered) the London market could now be turning definitely bullish. The Kaffir Index has been correcting in a long gently descending movement — a decline which suggests a lack of interest more than any real attack of selling pressure. Conclusion: If there are danger signals in this market, they are not yet apparent in the composite chart. The burden of proof continues to fall on the bears.



LONG-TERM PERSPECTIVE: Periodically, for the benefit of "near-sighted" readers, I like to step back and examine the market from the standpoint of history. The best way to know where you are is to note where you came from. Chart 2 traces the path (weekly) of the D-J Industrial Average from 1958 to the present. Here we see the explosive 1957-59 advance, the extended 1959 top, and the subsequent 1960 decline. The market touched bottom in October, 1960. The 1960-61 advance was abbreviated, but the '61 top was again an extended affair. The subsequent 1962 crash was extraordinarily damaging, and it accomplished something which no decline since 1946 had managed — it shattered the half-way level of the entire preceding (1957-61) advance. This constituted the most destructive technical performance of the whole post-war bull market, and it is interesting to note that many stocks are still far from peaks recorded between 1959 and 1961.



The violent compression set off by the 1962 collapse provided the technical strength for the advance which has lasted from June, 1962, to the present. This advance is one of the longest and most persistent in the history of the stock market. Note on Chart 2 that from 1959 to 1964 the upper reaches of the market were contained within the rising trendline. In mid-1964 the Industrial Average finally pushed above this trendline. Over the past few weeks Industrials appear to have been trying to pull away on the upside. This could constitute the beginning of a "blow-off" stage in the market. The question which every market student now asks is — how will we be able to identify the final top? My own suspicion is that the rise will not end in an easy-to-identify broad top such as 1959 or 1961. The current rise could well end in a "spear-point" peak and a subsequent rapid falling away or "waterfall" on the downside. Never have so many professionals watched Wall Street so carefully for any hint or sign of the end. Accordingly, the end, when it comes, could be one of the subtlest and most deceptive on record.

Chart 3 is a 67-year history of the Industrial Average again set to semi-logarithmic or ratio scale. Three trendlines have been drawn in, and these trendlines serve to trace the upper, lower and median limits of the Industrial action from 1897 to approximately 1954. Note that between 1897 and 1926 all bull and bear markets were contained within this long-term "growth channel." During 1927-29 Industrials pushed dramatically out of the channel for the first time. This extraordinary surge was followed by a collapse so violent that during 1932 the Average was seen to break below the bottom limits of the channel.

From 1932 to 1937 a new bull market took the Industrial Average back to the top of the channel again. The bear market which ended in 1942 took Industrials slightly below the bottom limits of the channel. Between 1942 and 1949 the Average seemed to "come to rest" in complete equilibrium near the middle of the channel.

In 1949 the present bull market began. The rise continued steadily into 1954, and it was during that year that the second great historic action began. In 1954 the Industrial Average pushed out of the upper limits of the channel. During that same year the Industrials accomplished an astounding feat (many believed it would never happen); during 1954 Industrials rose above their 1929 high of 381.

During the 1921-29 bull market the senior Average held above the upper limits of the channel for three years (1927-29). But it is amazing to note that Industrials have now held above the channel's upper limits for eleven consecutive years. This performance raises a number of important questions. Will the next bear market make up for the eleven year rise above the channel by taking Industrials below the lower channel limits again (as per 1932)? Or has a new growth channel been in effect since 1932? These are perhaps the most important technical questions facing the investor today. My personal opinion is that the next bear market will take Industrials below the lower channel limits again, a move which could take the Dow to the 200 level. Along these lines, history shows that every bear market has ultimately taken Industrials below the peak of the preceding bull market. The preceding bull market high was the 212.50 mark of 1946. Such a decline (to 200) now seems utterly impossible, but we should remember that ten to fifteen years ago the present advance seemed just as "impossible."

STOCKS: Follow-ups — on the dearth of news, the silver issues have been drifting off. Place stop-loss under Day at 9¼, continue to "sweat out" CMN. Gold stocks drifting from lack of interest. I doubt that much action will occur in golds until second half of the year when the British balance-of-payments will be affected by unfavorable seasonal pattern. The fundamentals (which I watch) continue to deteriorate in Britain. For instance, each week the Economist presents critical comparisons. Here is a typical sampling from this week's edition: British retail prices now 4.5% above retail prices one year ago! British export prices 3% above prices one year ago! British wages 4.1% above wages one year ago! Those are the fundamentals. As long as they continue, the British world trade position will deteriorate and the pound will remain in danger. The hedge continues to be gold.

Avco recommended in Letter 282 continues to be a problem. The 200-day moving average on AV is 22. AV is not acting well, but it has strong base at 20. Poor action, but I keep hoping. Baldwin-Lima on the other hand acts well and is holding after sharp run-up to 19. Sit with this one. Ogden (Letter 285) acting all right and should be held. Main rising trendline on OG comes in at 12½ and stock is holding well above this line.

VIETNAM AND ALL: It is extraordinary to note how few people (subscribers included) are aware of the split which is now rocking Washington regarding Vietnam. The split was first aired for the public by Hans Morgenthau in the Sunday (April 18) N. Y. Times ("We Are Deluding Ourselves in Vietnam"). Walter Lippmann, high priest of the liberal Democratic wing, next parted company with the Administration in Newsweek (April 12). It has been estimated that 40% of Congress disagrees with Johnson on Vietnam. But with the exception of Senator Morse, the majority of Congress has preferred to keep their thoughts to themselves.

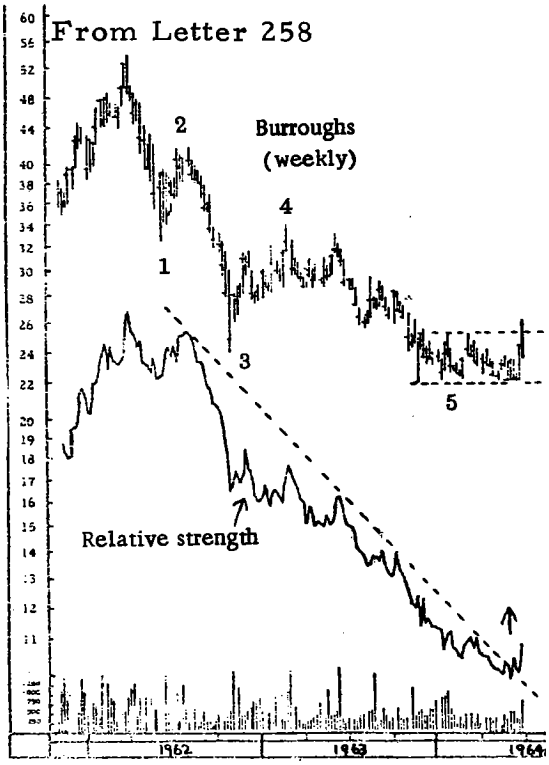
The liberal arguments, right or wrong, are worth knowing. Here they are: (1) The Vietnam affair is a civil war. The U. S. is the only foreign army on Vietnam soil. (2) There is no S. Vietnam government worthy of the name. The U. S. is committed to defend a "shadow" government which has lost most of the population by day — almost all of it by night. (3) Before the U. S. stepped up the war in Vietnam, there was a good chance that N. Vietnam would have become a sort of "Titoist" government, Communist but independent of China. This chance is now lost. (4) The U. S. is now committed to contain Communist China. It will be impossible to contain China in her own "backyard" — Asia. (5) Americans are not getting any straight reporting out of Vietnam. The Administration has "shut up" or "shipped out" every reporter who dared to tell a story which deviated from the U. S. version. (6) In an effort to mold public opinion, the U. S. issued a White Paper. This Paper was absurd in that it attempted to present "facts" after a new U. S. policy had been formulated and put into action (bombing N. Vietnam). The White Paper was simply a coverup, and a new Paper is now being readied in another attempt to silence the growing opposition. (7) The rainy season is fast approaching in Vietnam. This will interfere with our air attacks and favor the Vietcong. If the Vietcong has not quit now, it is ridiculous to think they will quit before the rainy season. (8) The attacks on N. Vietnam have now placed two world powers in a position where one of them must "lose face" — China or the U. S. This is an extremely dangerous situation. Lippmann and Morgenthau are of the opinion that we must "change our minds" and "get out."

This observer has not fully made up his own mind regarding the right and wrong of the Vietnam situation. But I am convinced that most people are only getting one-half of the story. And I am not yet convinced that the other half is the wrong one. Looking ahead (as an investor) I see President Johnson, a quick-tempered man who does not like to appear wrong, facing a China which is cold, calculating, patient, and now attempting to take over aggressive leadership of world Communism. China cannot afford to be shut out in Vietnam. Therefore, the outcome of the Vietnam war could be a long, drawn-out Korean-type affair. Or it could turn out to be something bigger. And in the background is the temptation (on the part of the U. S.) to knock out China's nuclear capabilities now. Obviously, time is against the U. S. in a "limited" war with China. It might pay subscribers to consider all this carefully in terms of long-term investing. The U. S. has now taken a firm stand. It is doubtful whether China considers herself to be in a position from which she can (or will) retreat.

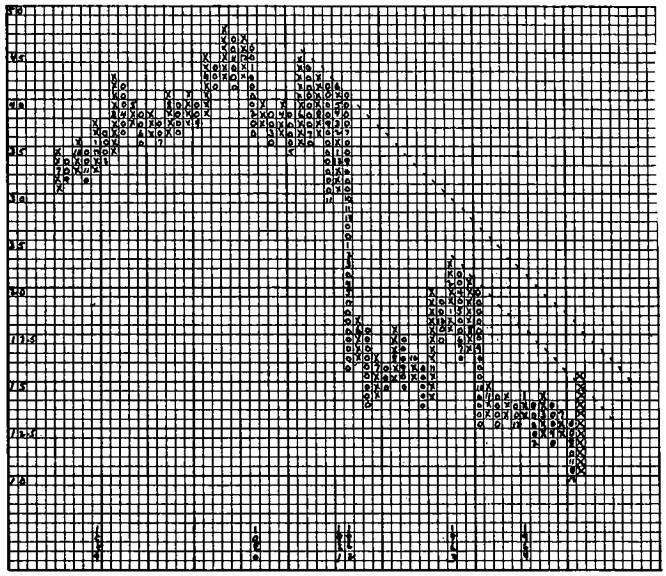
Back in Letter 258 when I first started recommending Burroughs I included a long-term (monthly) chart (see Page 4). This chart traced a major five-step decline. At that time I wrote (BGH was 24): "One point of particular interest in BGH is the fact that the collapse since the 1962 high has taken the form of five distinct legs (as marked on chart). This 5-leg pattern is often associated with the completion of a major movement in a stock, and it is, for instance, the formation which appeared during the Bucyrus-Erie decline." BGH subsequently rose 50%.

Obviously the action in BGH does not necessarily have to repeat in other issues. However, one stock which I have been watching with great interest is Fansteel Metallurgical Corp. FNL has undergone one of the most perfect 5-leg collapses on the board (see monthly chart). FNL during early 1965 touched what was probably its lowest level of market "popularity" (relative strength) in history — as seen on the chart (Page 4). In other words, FNL is a stock which has to all purposes completed a major bear market and dropped to an extreme in unpopularity. Between 1959 and 1964, in fact, FNL lost almost 80% of its market value.

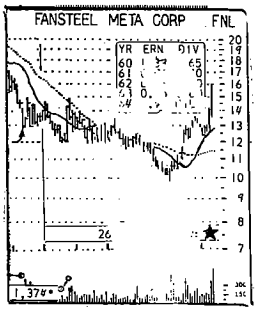
Turning to the long-term point & figure chart (Page 4) we see FNL now pushing above a series of tops at 14 (and thereby turning bullish). In the process, FNL has reversed the first of two bearish trendlines (the second occurs at 18). Finally, the small weekly chart shows volume coming in on the new rise in FNL, and this too is encouraging. For the quarter ending in March, FNL's earnings more than doubled, and thus we can surmise that the fundamentals are turning. FNL is now better than 30% above its 200-day moving average (dotted line), and this suggests that FNL might be in for at least a short-term correction. I believe the stock is an attractive speculation, and it may be purchased on declines (try to buy it as near to 13-14 as possible).

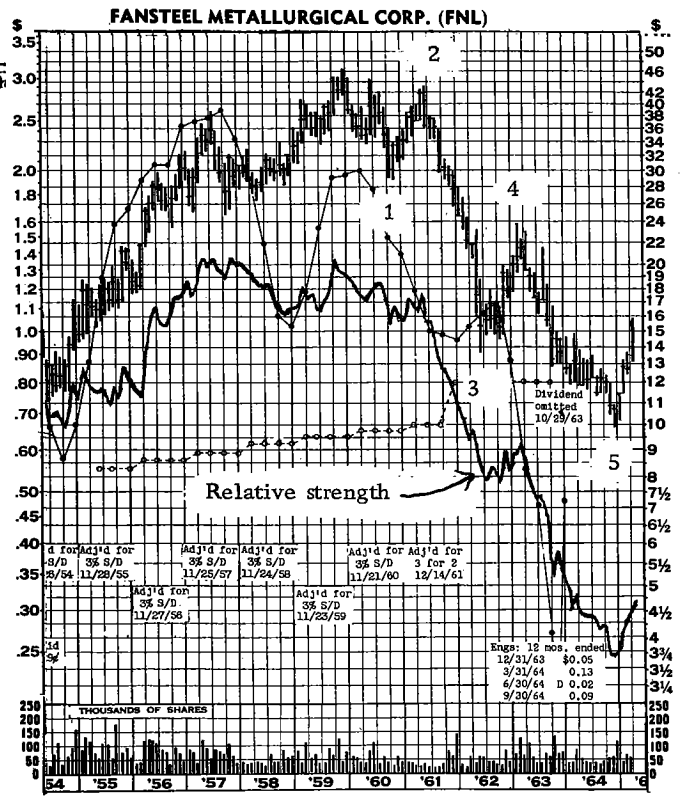


FANSTEEL METALLURGICAL CORPORATION (FNL)



MOMENTUM INDEX: This is the ratio provided by the S & P 425 Industrial Average on its end-of-the-month reading compared to that Average exactly one year ago. We follow this ratio monthly. On the latest (April 30) closing of 99.44, the "425" has advanced the Momentum Index to approximately 112 (see chart at bottom of page). Thus the Momentum Index gives evidence of attempting to reverse a descending trendline which has held in effect since November, 1963. This is a very important juncture for the Index and the market. If the S & P Average pushes up strongly from here, the Momentum Index will probably complete a reversal to the upside. Such action would suggest a market "blow-off." In other words, we are at a point where a 17 month decline in momentum could be about to reverse. A new rise in the Momentum Index could mark the beginning of a final speculative surge — an "explosion" which (in this writer's opinion) would probably spell the end of an era.





I have frequently commented about the extreme difficulty in picking stocks at this time. One reason (as I have mentioned) is the staggering competition among analysts and advisors to "pick the winner." Here is an example of the wild current scramble for market "know-how." It is reported that the Official Summary of Stock Transactions and Holdings (the S. E. C.'s summary of "insider" trading and transfers) is now one of the fastest growing periodicals in the nation! Circulation for this publication has jumped 23% (to 21,000) since January, 1965! (If you want to get on the list, write to the Superintendent of Documents, Government Printing Office, Washington, D. C. 20402 — Price $1.50).

* * *

Apology — I neglected to state that the large relative strength chart of LTV on Page 3 of Letter 286 was supplied courtesy of Ray * Signals, 141 B'way, N.Y.C. 6. In this issue — Chart 2 and small weekly bar charts courtesy of Quote Digest, 110 N. Lorraine, Wichita, Kansas. Large monthly chart of FNL courtesy of Securities Research Corp. 211 Congress Street, Boston, Mass. 02110. P & F chart of FNL courtesy of Chartcraft, Larchmont, New York. Chart of Burroughs from Letter 258 courtesy of Traders Research, P. O. Box 2644, St. Louis 16, Mo.